<u>Written testimony of David H. Brockway</u>

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I am not here today as an expert on the economic considerations relating to the taxation of capital gains, nor am I here to advocate any particular tax treatment for capital gains income or even to advocate fundamental tax reform itself. I was asked to appear because I was Chief of Staff of the Joint Committee on Taxation during the consideration of the Tax Reform Act of 1986 and thus have some experience in dealing with the issues involved in structuring fundamental tax reform legislation in general and in regard to the taxation of capital gains in particular. I recognize that the circumstances faced by the Congress and the Reagan Administration in 1986 were markedly different in a variety of respects from those that you and the next Congress will face if you go forward with this undertaking, and thus our experiences in 1986 are no more than reference points you should be aware of in plotting your own course and did not create a path you need to follow. I should also emphasize that the following represents a summary of my recollections of what occurred almost 30 years ago, and I am sure that others involved will have differing, and perhaps more valuable, recollections of how that legislation came to pass and viewpoints as to the lessons that might sensibly be drawn from that experience.

I am currently a partner at the law firm of Bingham McCutchen LLP, and my practice is focused primarily on corporate tax issues arising in the international context. While others at the firm may engage in lobbying on tax issues from time to time, I have no involvement in those matters. My own practice is, and has always been, strictly transactional and never has directly or indirectly involved lobbying either the legislative or the executive branch. While clients of the firm, and my own personal clients, obviously have significant interests in issues you will deal with in the course of your tax reform effort, I have not consulted with others at the firm or with my clients on the subject matter of my testimony here today, and I would like to make it clear that I am appearing strictly on my own personal behalf, not on behalf of my firm or any of its clients.

A key element of the 1986 Tax Reform Act was the elimination of the preferential tax rate for capital gains. That, however, was not as such a design objective of the reform effort itself but rather was a derivative of the consensus design constraints for that tax reform effort. While there had been several earlier comprehensive tax reform proposals made by different members, Senator Bradley developed a comprehensive and specific legislative proposal with a 30% top rate on ordinary income that he, together with Mr. Gephardt, introduced in 1984. The bill was structured to be revenue neutral over the 5-year estimating window then in use under the Gramm-Rudman budget procedures and was also structured to be distributionally neutral in the individual sector, with the benefits from the rate cuts for each income class roughly offset by revenue increases from base broadeners. Those constraints permitted tax reform to be considered on its own merits rather than as a veiled struggle between competing partisan or ideological agendas. Because at that time (and most likely at this time as well) comprehensive tax reform would not have been feasible without meaningful bi-partisan support, these design constraints were indispensible – they moved tax reform from a zero-chance talking point exercise up to a long-shot undertaking. In any event, those same constraints were subsequently adopted by Mr. Kemp in his design of the principal competing proposal that he introduced with Senator Kasten, and they likewise were adopted as a given by the Reagan Administration and both houses of Congress at all times during the consideration of the 1986 Act. Thus, throughout that process, there was a clear consensus of all involved that (i) the legislation should be revenue neutral over the 5-year budget window, and (ii) of particular significance to the decisions ultimately made in that process to increase the capital gains tax rate, the distributional impact of the individual tax changes should be at least as progressive as existing law. (In fact, the overall estimated impact of the Administration's proposal and the bills considered by both houses was to make the distributional burden of the individual income tax slightly more progressive than prior law.[1]) Another key component, probably indispensable to achieving a politically viable package, was a shift of tax burden off of the individual sector onto corporate sector of $100 billion over the 5-year budget estimating window, or the equivalent of a shift of perhaps $30 or $40 billion a year today. That shift was first introduced in the Reagan Administration's proposal, and it was adopted by both committees and reflected in the House bill, the Senate bill and the final legislation. Finally, there was a consensus by the both by the Administration and the leaders of both parties in both houses that the Joint Committee on Taxation revenue estimates, based upon its historic revenue estimating conventions, would be dispositive in determining the revenue and distributional impacts of the various changes under consideration.

As things played out, the distributional constraint for the highest individual income class proved to be the binding constraint at each stage of the 1986 tax reform process. It turned out that the overall revenue constraint and the distributional burdens for the lower income classes could be satisfied with far less difficulty by adjustments to where the break points between individual income tax brackets were set. At the upper-income levels, however, that technique had no possibility of working because the prior law average tax rate for these taxpayers was near or above the top rate in the new rate structure. Therefore, the distributional neutrality constraint could only be satisfied by adopting base broadeners that had a disproportionate impact on high income groups under current system, and politically viable base broadeners having that profile were very difficult to come by. If you decide to adopt a distributional neutrality constraint, and I believe you will need to in order to succeed in enacting comprehensive tax reform legislation, you are likely to have the same difficulty. Apart from increasing current rates on capital gain income, there are only a limited number of changes you are likely to consider that would be concentrated in highest income levels (items such as, for example, limitations on certain charitable deduction planning techniques, employee stock options, tax preferred retirement plan rules for highly-compensated employees, and changes to the taxation of closely-held business), and any such changes are likely to be as politically challenging as increasing the capital gains rate. I suspect that items such as further limits on the mortgage interest deduction likely are likely to be of proportionately greater significance for upper-middle income taxpayers than they will be those in the highest income brackets. The staffs will have to go on a scavenger hunt to find possible base broadeners for you to consider in order to satisfy the distributional neutrality constraint, and they will need to exercise a fair amount of creativity because it is likely that the base broadeners you will need do not all appear in the JCT tax expenditure pamphlets.[2] Once

[1] At the time, in contrast to what I understand may be the case today, there was no attempt to allocate changes in the corporate tax burden among different individual income classes. I personally believe that it is a serious mistake to attempt to allocate the corporate tax burden among classes of individuals.

[2] The search for base broadeners should not be confined to those previously identified and listed in the tax expenditure budgets. Particularly in regard to taxation of business operations and income from capital assets, the reasons why the actual revenue generated by the current system is so much less than the rate structure might imply is not solely limited to various explicit tax incentive provisions consciously adopted to encourage certain economic

that search has been exhausted, you may well find that increasing the capital gains rate, however unpalatable, is a less unappealing alternative than other technically feasible approaches that might satisfy the distributional neutrality constraint in a reform package that has a top rate on ordinary income in the mid-twenties.

In any event, as I am sure you are aware, if you do adopt distributional neutrality as a design constraint, a crucial issue you will have to agree upon is the base line you that start with – current law with, for example, the 10% temporary individual rate cuts and the AMT fix expiring as scheduled – or current policy assuming that those and other expiring provisions would be extended. The distribution of relative tax burden of those two possible base cases differs meaningfully, which will have as large an impact on the design of a tax reform package, including in particular the tax rate on capital gains, as does the obvious question of which aggregate revenue base line the reform package would need to meet in order to be viewed as budget neutral, assuming that is also a design constraint.

At the risk of over-constraining the process, you might also consider refining the distributional analysis a little at the upper end, because my guess the biggest distribution battle this time around will be between the top 1 or 2 percent income group and the rest of the top 20 percent. That, I believe, is where the most significant potential for redistribution of tax burdens among income classes is likely to show up as you reduce rates and replace the lost revenue with base broadeners. My guess is that there will be a natural tendency, unless you have constraints designed to prevent it, to shift tax burden off of the very high income groups onto the high income groups – off of individuals earning, say, $2 million a year or more onto those making from $500,000 to $2 million. While such a shift could probably be hidden in the distributional tables if the income classes used in those tables are large enough, I suspect it probably would implicitly be recognized by your constituents as they become aware of the impact of tax reform on their tax burdens. While a reasonable argument might be made that distributional shifts among those that have a lot and those that have an enormous amount should not be of vital concern as a policy matter, I believe it will have a meaningful effect on the political viability of tax reform and thus should seriously be considered.

As I mentioned earlier, the taxation of capital gains at ordinary income rates was not an initial design element of the tax reform proposal of the Reagan Administration nor was it an objective, in and of itself, of either the House or Senate bill. It was, instead, a last resort response in both committees to the need to satisfy the distributional neutrality design constraint that the participants had accepted without necessarily realizing the implications in regard to the taxation of capital gains. In the House Ways and Means Committee mark up, the rate was increased from 20% to 22% only at the very last moment to deal with a revenue shortfall. After a long and difficult process, a bi-partisan consensus had been reached on the terms of a bill that, among other elements, had a 20% top rate on capital gains. Just before the Committee was to reconvene and vote the bill out, the revenue estimators came up to me at the witness table and told me that they had discovered an error in the modeling and we were $17 billion short over the 5-year budget window. It was already early evening when that catastrophe hit. We were sent back to the drawing board to come up with proposals that would fill the revenue hole and comply

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activity but instead stems to a considerable degree from less than obvious and probably unintended interactions between the complex rules needed to measure and tax such income.

with the distributional constraints, and by very late in the evening the only way we could figure out how to solve the problem in conformity with the distributional constraints was a package of changes that included an increase in the capital gains rate from 20% to 22%. That increase was resisted strongly by Chairman Rostenkowski because he understood its political ramifications and the threat it presented to passage of the bill, but we were unable to develop alternative proposals at that time that would satisfy the distributional constraint. In fact, that last minute and unanticipated increase, when combined with the very long wait for the Committee Members that evening without clear information as to the nature of the problems we were struggling to address, caused significant defections among the minority, some of whom understandably thought we were engaged in a bait and switch. That, I think, was the principal reason the bill lost the vote on the rule when first put to the House floor. The bill was only revived by the very energetic intervention of the Administration over the next few days to secure enough votes from the minority so that wavering members of the majority were also willing to vote to let the bill go to the next stage (where the smart money believed it was fated to wither and die).

The main point here is not just to tell a war story, but rather to underscore that the capital gains rate increase in the House bill was the absolute last resort and driven by the distributional constraints more than anything else. There is, however, another point I would like to make in connection with this incident. It will be very difficult for you to move a bill to completion if you don't trust the staffs, including in particular the revenue estimating staffs, to be honest and to do their absolute bests to represent you and the interests of the general public. They are individuals of the highest integrity and dedication. I don't mean to say that they won't make some mistakes along the way – that one was a big one and we had a similar $17 billion event with Senator Packwood that was discovered after the bill passed the Senate – but just that the mistakes, although inevitable, will be honest ones, and the staffs will do their absolute bests to shoot straight.[3]

In the Senate, the original mark prepared by Chairman Packwood and considered by the Finance Committee did not attempt to tax capital gains and ordinary income using the same rate structure. An increase in the capital gains rate was first seriously considered by the Committee only after his initial version crashed and burned and Chairman Packwood responded by presenting a much more radical program with a 25% top rate on all income, ordinary and capital. Even in that context, the increase in the capital gains rate was not considered as a goal in and of itself, but rather as a necessity to meet the design constraint of distributional neutrality. At what ultimately became a 27% top rate on ordinary income in the Finance Committee bill, the only plausible changes that we were able to indentify that would offset the reduction in tax burden on upper-income taxpayers due to the ordinary income tax rate cut were a combination of the passive loss limitation and an increase in the capital gains rate to the same rate as ordinary income. Having been deeply involved in this aspect of the Senate Finance Committee's deliberations, I am confident that the increase in the capital gains rate was considered and

[3] I also don't mean to say that the staff members don't have policy and political views. Of course they do. For example, most, regardless of their partisan affiliations, are likely to be "reformers" at heart, with a very healthy skepticism about preferential tax treatment for any special activity. That said, they are professionals of the highest order who have worked for you for a long time and accept that there are reasons why Congress may want to make distinctions in the tax burdens borne by different activities and different groups of taxpayers, and they will work hard to implement your decisions in that regard whether or not they happen to share your belief that such distinctions are wise.

adopted only as a last resort because we could not identify any other viable base broadeners that would satisfy the distributional constraint.

It may be that in this attempt at tax reform you decide not to bind yourselves to a distributional neutrality constraint, but I believe it would be unwise to do so both because I personally believe it would be wrong as a matter of policy in a number of respects and because I do not believe it would be possible to convince the general public to accept the loss of their existing tax preferences unless they believe in the fairness of the overall legislation. Needless to say, the politics of this enterprise are fundamentally different than a rate cut in which all income classes participate, even if their relative benefits from the tax cut are not necessarily proportionate to their existing tax burdens. My own assessment of the political realities, for what it's worth, is that tax reform is not worth pursuing if you cannot meet a distributional neutrality constraint because I do not believe you would be able to pull it off and, even if somehow you could, I don't think it would last because I think it would ultimately rejected by the general public as unfair.[4]

The necessity of turning to a capital gains rate increase in 1986 to satisfy the distributional neutrality constraints obviously does not necessarily mean that you will be forced to do so as well. It is possible that, even if you do bind yourself to a distributional neutrality constraint, you will be able to identify other base broadeners that disproportionately impact upper-income taxpayers and that are adequate to balance the reduction in the top rate on ordinary income without the need to resort to an increase in the capital gains rate. I am not close enough to the numbers and do not have any sense of the work that has been done by the staffs on this front to date. From my experience, however, I would be very surprised if you would be able to design and enact a tax reform package with a top individual tax rate on ordinary income in the mid-twenties without increasing the capital gains rate to the ordinary income rate.[5] Accordingly, in my view, your willingness to adopt an increase in the capital gains rate, assuming some adequate rate objective for ordinary income can be achieved, is a threshold issue to be considered at the outset of the process.

If you do decide to retain a preferential rate for capital gains, there are other important issues regarding the taxation of capital gains that you should consider in this process. The definition of what qualifies for the preferential rate should be reexamined in light of the policy reasons that persuade you to retain it. There is no particular reason to believe that the current definitions are in all respects consistent with the particular investment activities that you conclude should be afforded a preferential rate.

Moreover, as long as there is any difference between the tax rates imposed on ordinary income and capital gains, there will be arbitrage activity designed to convert ordinary income (and short-term capital gains not qualifying for the preferential rate) into long-term capital gains

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[4] At its core, tax policy is not some scientific exercise that has a correct answer that can be determined by economic models implementing some academic theory; it, instead, is a considered response to, and implementation of, what the body politic accepts as the least objectional way of raising the revenue needed to operate the government.

[5] I suspect that you might be able to do it with a slight rate differential, but once you get within 2 or 3 percentage points there does not seem to be much to be gained by not going all in.

and to convert capital losses into ordinary losses. The larger the spread in rates and the fewer and less effective the speed bumps you put in the Code to discourage this activity, the more arbitrage activity there will be. The reality is that arbitrage is an inevitable aspect of any tax system because the law generally, and the tax law in particular, is based on relatively crude attempts to compartmentalize a very complex society and dynamic economic behavior. It is not possible to create a system that does not have lines providing different treatment for activities defined by the law to be different but which, as cases get close to the line, do not in substance differ all that much. People like me will be hired to figure out how to exploit these differentials, and in due time we will succeed to a certain extent in doing so. Nonetheless, while elimination of all tax driven arbitrage is not a realistic objective, the reduction of such arbitrage in my view should be a core objective of any reform plan. Therefore, from this perspective at least, a reduction of the gap between the capital gains and ordinary income rates is a worthwhile goal in and of itself that should not be viewed as failure even if the gap is not eliminated entirely.

I do not, however, want to oversell the simplification that would come from merging the capital gains and ordinary income tax rates. While the reduction or elimination of the rate differential would, without a doubt, substantially reduce tax arbitrage activity, it is important to understand that even taxing both at the same rates would not eliminate the need for distinguishing between capital gains, or at least certain categories of capital gains, and ordinary income. The current distinction between capital gains and losses on the one hand, and ordinary income and losses on the other, serves two purposes: (i) it provides tax relief for long-term capital gain income for various policy reasons, and (ii) it limits the cherry-picking that is available to taxpayers having both appreciated and depreciated assets. A necessary component of our tax system is that, to some significant degree, income and loss from the appreciation and depreciation in value of assets will be taxed on a realization basis rather than an economic accrual basis. Because, as a general proposition, the taxpayer has control over whether and when to recognize income and loss from the appreciation and depreciation of investment assets, there is a very significant economic incentive on taxpayers to recognize for tax purposes the losses on any assets that have declined in value and defer recognition on assets with gains. Since assets receive a step up in basis at death and since charitable deductions are allowed for the fair market value of contributed assets rather than their tax basis, increases in the rate of tax imposed on capital assets will also tend to increase these distortive elements of our realization-based system. These incentives exists entirely without regard to whether capital gains receive a preferential rate – indeed, they exist with respect to assets taxed at ordinary income rates (as they do now in respect to capital assets in the corporate sector) as long as gains are not taxable until realized. In addition, since these incentives are more or less proportional to the capital gains rate, the higher the rate is raised, even if to make it match the ordinary income rate, the greater the pressure there will be on taxpayers to engage in distortive behavior. I do not believe you could operate the system without retaining some limitation on this activity, but it need not necessarily take the form of the current limitation. It probably would be worthwhile to consider in addition other techniques for dealing with the cherry-picking problem such as expanding the rules requiring mark-to-market treatment or the rules requiring the capitalization of losses where a taxpayer holds appreciated property. In any event, while I think it is an important consideration that should be kept in mind in the design of a comprehensive tax reform proposal, I personally do not believe that the inevitable distortions created by the increased incentive to defer the recognition of capital gains or engage in arbitrage activity to convert capital losses into ordinary losses that would flow from increasing the rate imposed on realized capital gains income is a sufficient reason not to reduce or eliminate that gap.

As a tax technician by profession, I am generally quite skeptical about preferential tax treatment for particular forms of income or income from particular categories of economic activity, and from that perspective I personally start with a reasonably strong bias against a preferential rate for capital gains. Nonetheless, one can observe that for the past almost 100 years that we have had an income tax system, a preferential rate for capital gains has been the norm, with only the briefest period during which the rate structure for capital gains and ordinary income was the same. Preferential treatment of capital gains is, moreover, a common feature of most foreign income tax systems. After all the fanfare about tax reform in 1986, in 5 years' time the capital gains rate differential was reintroduced. Thus, without having to debate their merits, we must accept that there are powerful factors that operate as a political reality to impose an upper limit on capital gains rates and that, realistically, it is unlikely that it will be possible to overcome those factors for any long-term period. My guess is that the necessity of taxing capital gains on a realization basis probably puts an upper limit on the effectiveness of increases in the capital gains tax rate at some point in the mid to high twenties. I suspect that there are other powerful contributing factors at work that also operate to put a practical upper limit on the capital gains rate. We can, however, look back over our history and see that for long periods of time we have successfully operated with a 25% rate on capital gain income in the individual sector (and 35% in the corporate sector), so I think we can also be confident that a capital gains rate in that range would be viable.

If one accepts that, for whatever reasons, it is unlikely an individual capital gains rate much in excess of 25% could be realistically sustained be on a long-term basis, that would also effectively impose an upper limit on the ordinary income rate as well if a fundamental design feature of the tax reform proposal is to tax capital gains and ordinary income at the same rates. If the same treatment is provided for ordinary income and capital gains, that not only would impose a governor on possible future increases in the top marginal income rate on ordinary income, but it would also operate to impose a practical limitation on the amount of income that could be raised from the individual income tax system. Consequently, if at some point a decision were made to raise revenues significantly above current levels, this dynamic should operate to push for the revenue increases to be sourced elsewhere. This in turn should, in theory at least, provide some stability for the new rate structure – the top individual tax rate could not as a practical matter be reduced to any significant degree thereafter because of the revenue loss with respect to ordinary income, and the ordinary income rate could not be raised significantly without breaking the link between capital gains and ordinary income. Whether that stabilizing tendency would be sufficient in practice to counter the pressures to reduce the capital gains rate or increase the ordinary income rate is, however, far from clear. It only worked for 5 years after 1986. If you do succeed in adopting a comprehensive tax reform and it contains, as the distributional constraint may dictate, the same rate structure for capital gains as for ordinary income, I would hope future Congresses will learn from that experience and resist both the urge to reduce capital gains rates and the urge to increase the top rate on ordinary income.

Thank you very much for this opportunity to appear at this hearing. As I have mentioned to your staffs, I would be happy to continue discussions with you or your staffs on this and other aspects of tax reform at any future time that you or they might request.